

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200924041**

Release Date: 6/12/2009

CC:CORP:04
POSTF-127191-08

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 1059.00-00

date: February 13, 2009

to: Judith A. Cody, Team Manager Group 1322
LMSB: Communications, Technology & Media

from: Richard K. Passales, Senior Counsel, CC:CORP:04

subject: Section 1059(e)(1)(A)(ii)

LEGEND

Parent =

Sub =

Redeeming Corp =

a =

Date 1 =

Date 2 =

Date 3 =

Issue

In the case of a section 1059(e)(1)(A)(ii) transaction, does a taxpayer reduce only the basis in the redeemed shares by the nontaxed portion of a non pro rata redemption distribution, or also the basis in the nonredeemed shares.

Conclusion

In the case of a section 1059(e)(1)(A)(ii) redemption to which section 302(d), and section 301 applies, the basis of the redeemed shares is reduced (but not below zero) by the nontaxed portion of the dividend. To the extent the nontaxed portion of the dividend exceeds basis in the redeemed shares, basis in the nonredeemed shares is also reduced.

Facts

Parent, wholly owns Sub, a member of its consolidated group. Sub owns a% of the common stock of Redeeming Corp. Pursuant to certain agreements entered into on Date 1 and Date 2, Redeeming Corp agreed to buy back Sub's common stock at various times throughout the years covered by Date 1, Date 2, and Date 3. These redemptions of Sub's shares were not pro-rata as to all shareholders of the Redeeming Corp and did not qualify for sale or exchange treatment under Internal Revenue Code¹ section 302(a).

Because the redemptions were not pro rata as to all Redeeming Corp shareholders, Parent applied section 1059. Parent treated the redemption proceeds as the receipt of a dividend under section 301, and claimed a dividends received deduction under section 243(a)(1). The dividends received deduction was the same amount as the "nontaxed portion" for purposes of section 1059(a)(2). On Parent's original return, Parent determined Sub's section 1059(a)(2) gain by reducing only the basis of the shares redeemed by the nontaxed portion (the amount of the dividends received deduction).

Parent subsequently amended its return after concluding that the basis of Sub's non-redeemed shares was also available for reduction if the redemption was subject to section 1059(e)(1)(A)(ii). Parent shifted the basis of the redeemed shares to its nonredeemed shares and then reduced the basis of the nonredeemed shares by the nontaxed portion of the redemption distribution. Parent is seeking a refund because the shifting of the basis of the redeemed shares to the non-redeemed shares followed by the reduction of the basis by the nontaxed portion did not result in any gain under section 1059(a)(2).

¹ Unless otherwise noted all references to section are to the Internal Revenue Code of 1986, as amended and all references to "§" are to Treasury Regulations.

Law

Section 1059(a) generally provides that if a corporation receives an extraordinary dividend with respect to a share of stock and such corporation has not held the stock for more than 2 years before the dividend announcement date, the basis of the stock will be reduced (but not below zero) by the non-taxed portion. If the non-taxed portion of such dividend exceeds such basis, the excess shall be treated as gain from the sale or exchange of such stock for the taxable year in which the extraordinary dividend was received.

Section 1059(b) defines the nontaxed portion of any dividend as the excess (if any) of the amount of the distribution over the taxable portion of the distribution. The taxable portion of any dividend is the portion of such dividend which is included in gross income reduced by the amount of any deduction allowable with respect to such dividend under section 243, 244, or 245.

Section 1059(e)(1)(A) provides that certain redemptions of stock are to be treated as extraordinary dividends. Section 1059(e)(1)(A)(ii) provides for redemptions of stock which are not pro rata as to all shareholders. Section 1059(e)(1)(A)(iii) provides for redemptions which would not have been treated (in whole or in part) as a dividend if—(I) any options had not been taken into account under section 318(a)(4), or (II) section 304 had not applied.

The flush language to section 1059(e)(1)(A) provides that any amount treated as a dividend with respect to such redemption is treated as an extraordinary dividend to which paragraphs (1) and (2) of subsection (a) will apply without regard to the period the taxpayer held the stock. In the case of a redemption described in clause (iii), only the basis in the stock redeemed will be taken into account under subsection (a).

Section 302(a) provides that if a corporation redeems its stock (within the meaning of section 317(b)), the redemption will be treated as an exchange if section 302(b) applies. For a redemption to be treated as an exchange under section 302(b), (1) the redemption must not be substantially similar to a dividend; (2) the redemption is substantially disproportionate; (3) the redemption completely terminates a shareholder's interest in the corporation; or (4) the redemption is in connection with a qualifying partial liquidation.

Section 302(d) provides that if a corporation redeems its stock, and section 302(a) does not apply, the redemption will be treated as a distribution of property to which section 301 applies.

Section 301(a) provides that a distribution of property made by a corporation to its shareholder with respect to its stock is treated in the manner provided in section 301(c). Section 301(c)(1) provides that the amount of the distribution which is a

dividend (as defined in section 316) is included in gross income. Section 301(c)(2) provides that the portion of the distribution which is not a dividend is applied against and reduces the adjusted basis of the stock. Section 301(c)(3) provides that amounts of the distribution in excess of the adjusted basis are treated as gain from the sale or exchange of property.

Section 243 provides for a dividends received deduction upon the receipt by a corporation of the amount of a dividend received from a domestic corporation. The amount of the deduction is based on the percentages set forth in section 243(a) and 243(b).

Analysis

Parent properly applied section 302(d) and section 1059(e)(1)(A)(ii) to the Redeeming Corp's redemption of Sub's common stock. Parent's initial reduction of Sub's basis in only the redeemed shares by the non-taxed portion of the dividend was in error. Under Section 1059(e)(1)(A)(ii), a shareholder is required to reduce the basis of the nonredeemed shares to the extent the nontaxed portion of the dividend exceeds the shareholder's basis in the redeemed shares. The Conference Report accompanying the Deficit Reduction Act of 1984 which enacted section 1059 makes this clear. The relevant section provides:

Finally, the conferees wish to make clear their intention that if a redemption distribution is treated as a distribution under section 301 rather than a sale or exchange of the redeemed shares under section 302(a), the distribution is treated as made, pro rata, with respect to the stock of the shareholder which is not redeemed.² (Emphasis added).

This language indicates that a redemption distribution is to be treated consistently with an actual section 301 distribution which is made pro rata with respect to all the shares of the class entitled to receive a distribution.³

Additionally, the flush language of section 1059(e)(1)(A) states that in the case of a redemption to which clause (iii) applies (redemptions to which sections 318(a)(4) or section 304 apply), only the basis in the stock redeemed may be taken into account under subsection (a). Section 1059(e)(1)(A)(iii) and the last sentence of the flush language were added in 1997⁴ and is often referred to as the "anti-Seagram-DuPont

² H.R. Rep. No. 861, 98th Cong. 2d Sess. at 817.

³ See *W. Taylor Johnson v. United States*, 435 F. 2d 1257, 1259 (4th Cir. 1971)(holding that section 301(c)(2) must be applied to reduce the basis of each stock with respect to which a pro rata distribution was received).

⁴ Pub. L. No. 105-34, § 1011(b), 111 Stat. 788, 913 (1997); Pub. L. No. 105-34, § 1013(b), 111 Stat. 788, 918 (1997).

rule”⁵ When adding this additional language, the 1997 Conference Report makes clear that this limitation on basis recovery to only the shares redeemed is a departure from the general application of section 1059(a)(1) and (a)(2).⁶ Accordingly, it is appropriate to read the limitation in the flush language as applicable only to transactions subject to clause (iii).

Conclusion

Parent correctly reduced the basis of both the redeemed and the nonredeemed shares to the redemption transactions covered by Date 1, Date 2, and Date 3 in its amended return. Parent may shift the basis of the redeemed stock to the nonredeemed stock pro rata and then reduce the basis of the non redeemed shares by the nontaxed portion of the distribution.

Please call (202 622-7530 if you have any further questions.

⁵ H.R. Rep. No. 148, 105th Cong. 1st Sess. at 459.

⁶ H.R. Rep. No. 220, 105th Cong. 1st Sess. at 526.